

TESTIMONY OF
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BEFORE THE
COMMITTEE ON GOVERNMENT REFORM

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Chairman Davis and members of the Committee, thank you for the opportunity to address your concerns on the use of non-tariff trade barriers by the People's Republic of China, particularly in the area of government procurement of U.S. computer software.

In the more than 20 years since China began its process of internal economic reform, the quantity of U.S. goods sold in China has expanded dramatically. Since China joined the World Trade Organization in 2001, growth in China's market for U.S. products has only accelerated. In 2004, U.S. exports to China totaled \$35 billion, nearly double the total for 2001. In fact, from 2001 to 2004, U.S. exports to China increased nearly eight times faster than U.S. exports to the rest of the world. As a result, China rose from our ninth largest export market in 2001 to our fifth largest export market in 2004. During that same time, of course, China's exports to the United States (and to the rest of the world) have also exploded. In 2004, imports from China totaled \$197 billion, nearly double the total for 2001, and China is now the United States' second largest supplier.

Clearly, China's economic emergence presents both challenges and opportunities for U.S. manufacturers, farmers, service providers and workers. While there is much positive to say about our success in penetrating the Chinese market, there is understandable concern that certain Chinese trade practices have frustrated efforts to further open the market, or have in other ways contributed to our large and growing trade deficit with China.

There are several areas where we have problems with China's trade practices, including China's efforts to implement its WTO commitments, and this Administration is working vigorously to address those, using the most effective tools at our disposal, including our trade remedy laws. Let me first put our trade agenda in context. Then, I will focus on one area in which China's policies and practices put U.S. firms, products or services, at an unfair disadvantage in the Chinese market – the government procurement of software.

China's WTO Compliance

In its accession agreement to the WTO, China agreed to extensive, far-reaching and often complex commitments to change its trade regime, at all levels of government. China committed to implement a set of sweeping reforms that required it to lower trade barriers in virtually every sector of the economy, to provide national treatment and improved market access to goods and services imported from the United States and other WTO members, and to protect intellectual property rights (IPR). China also agreed to special rules regarding subsidies and the operation of

state-owned enterprises, in light of the state's large role in China's economy. In accepting China as a fellow WTO member, the United States also secured a number of significant concessions from China that protect U.S. interests during China's WTO implementation stage. Implementation should be substantially completed – if China fully adheres to the agreed schedule – by December 11, 2007.

To date, while China's efforts to fulfill its WTO commitments are impressive, they are far from complete. At times, China's efforts have been unsatisfactory, and the Administration has responded with appropriate steps in such cases. The first year of China's WTO membership (2002) saw significant progress, as China took steps to repeal, revise or enact more than one thousand laws, regulations and other measures to bring its trading system into compliance with WTO standards. In 2003, however, China's WTO implementation efforts lost momentum, and we identified numerous specific WTO-related problems.

In response, the Administration stepped up its efforts to engage China's senior leaders. In December 2003, President Bush and China's Premier, Wen Jiabao, committed to upgrade the level of economic interaction and to undertake an intensive program of bilateral interaction with a view to resolving problems in the U.S.-China trade relationship. Premier Wen also committed to facilitate the increase of U.S. exports to China. This new approach was exemplified by the highly constructive Joint Commission on Commerce and Trade (JCCT) meeting in April 2004, with Vice Premier Wu Yi chairing the Chinese side and Secretary of Commerce Evans and United States Trade Representative Zoellick chairing the U.S. side. At that meeting, which followed a series of frank exchanges covering a wide range of issues in late 2003 and early 2004, the two sides achieved the resolution of no fewer than seven potential disputes over China's WTO compliance. Those successes ranged across the economic spectrum, from wireless standards to biotechnology to trading rights and distribution services.

At the same time, when our discussions with China were not successful, we did not hesitate to use the full range of tools made available to us as a result of China's WTO accession. The United States filed, and was able to successfully resolve, the first-ever dispute settlement case brought against China at the WTO. In that case, the United States, with support from four other WTO members, challenged discriminatory value-added tax policies that favored Chinese-produced semiconductors over imported semiconductors. In July 2004, about three months after the United States had initiated the case, China agreed to end its discriminatory policies, allowing U.S. manufacturers to preserve and expand their \$2 billion export business to China.

Key Problem Areas

Our trade relationship with China is large and growing, so it is not surprising that despite successes in a number of areas, problems still remain and new ones have emerged. Of key concern is when China's implementation of its WTO commitments lags in areas in which the United States has a competitive advantage, particularly where innovation or technology plays a key role. At present, we are pressing China in the following priority areas:

- The Administration places the highest priority on stemming the tide of intellectual property rights (IPR) infringement in China. Counterfeiting and piracy in China are at

record levels and are hurting a wide range of U.S. businesses. On April 29, USTR released the results of its special Out-of-Cycle Review, or OCR, of the IPR situation in China. We concluded that while China has recently undertaken a number of serious efforts at the national level to address this situation, such as lowering the value thresholds that trigger criminal investigations and prosecutions, these steps have not significantly reduced IPR infringements across China. Therefore, we have elevated China to the Priority Watch List. We will use this year's JCCT (likely to take place in July) to focus additional attention on this issue, including through the pursuit of clear benchmarks to ensure China's progress on IPR protection. We will use the TRIPS Agreement's transparency provisions to obtain specific evidence from China on the operation of its IPR enforcement regime, and we will work closely with industry with an eye toward utilizing all available WTO procedures to bring China into compliance with its TRIPS obligations.

- Supplementing these bilateral IPR efforts, the Administration has taken comprehensive action to block trade around the world in counterfeit and pirated goods through the Strategy Targeting Organized Piracy (STOP!), a U.S. government-wide initiative begun in October 2004 to empower U.S. businesses to secure and enforce their intellectual property rights in overseas markets, to stop fakes at U.S. borders, to expose international counterfeiters and pirates, to keep global supply chains free of infringing goods, to dismantle criminal enterprises that steal U.S. intellectual property and to reach out to like-minded U.S. trading partners in order to build an international coalition to stop counterfeiting and piracy worldwide.
- Since acceding to the WTO, China has periodically resorted to policies -- including in the areas of standards and government procurement -- that limit market access by non-Chinese origin goods and that aim to extract technology and intellectual property from foreign rights-holders. The objective of these policies seems to be to support the development of Chinese industries that are higher up the economic value chain than the industries that make up China's current labor-intensive base, or simply to protect less-competitive domestic industries. Of particular concern is China's recent proposal to implement restrictive government procurement policies for software, which I will address below. The United States and China made important progress toward resolving conflicts over a number of these industrial policies in 2004, but more work needs to be done, and the advent of new or similar policies in the future will require continued vigilance. In particular, we will continue to focus on standards policy that aims to limit foreign high-tech and other products' market access in China.
- While China has implemented its commitment to allow companies and individuals to import goods into China directly without having to use a middleman, China has been slow to permit our companies to freely distribute those products within China at the wholesale and retail level. China did issue regulations calling for timely implementation of its WTO commitment to open up wholesaling and retailing to foreign companies by December 2004. However, U.S. and other foreign companies have encountered impediments to actually providing these services because of ambiguities in the application of these regulations, as well as related licensing procedures. The

Administration has been pressing the Chinese authorities to clarify these procedures so that our companies can take advantage of the rights that they have in the wholesaling and retailing areas. Meanwhile, one segment of the distribution services sector – direct selling – is causing particular concern. Not only has China failed to implement timely regulations, but China is also considering restrictions that would make it difficult or impossible for U.S. direct selling companies to operate in China. The Administration has made clear its serious concerns in this area.

- While the United States enjoys a substantial surplus in trade in services with China, and the market for U.S. service providers in China is increasingly promising, problems remain in a number of important service sectors. Through an opaque regulatory process, overly burdensome licensing and operating requirements, and other means, Chinese regulatory authorities continue to frustrate efforts of U.S. providers of insurance, express delivery, telecommunications and other services to achieve their full market potential in China.
- With U.S. agricultural exports totaling \$5.5 billion in 2004, China has become one of the fastest growing overseas markets for U.S. farmers. Despite this growth, however, China's regulation of the agricultural sector is beset by uncertainty. Capricious practices by Chinese customs and quarantine officials can delay or halt shipments of agricultural products into China, while sanitary and phytosanitary standards with questionable scientific bases and a generally opaque regulatory regime frequently bedevil traders in agricultural commodities. While the Administration was able to make substantial headway on a number of key issues in agricultural trade in 2004, particularly in the area of biotechnology approvals and the removal of problematic sanitary and phytosanitary measures that had been curtailing trade, maintaining and improving China's adherence to WTO rules in the area of agriculture will require continued high-level attention in the months and years to come. Currently, one of our top priorities in this area is for China to re-open its market to U.S. beef based on internationally accepted scientific standards for human and animal health.
- While China's Ministry of Commerce has made laudable moves toward adopting WTO transparency norms, other ministries and agencies have lagged behind. As a result, China's regulatory regimes continue to suffer from opacity, frustrating efforts of foreign – and domestic – businesses to achieve the potential benefits of China's WTO accession. The Administration remains committed to seeking improvements in this area.

Let me now address the specific problem area that the Committee has raised: the procurement of software by the Chinese Government.

Government Procurement of Software

In 2002, China enacted the Government Procurement Law, which provides generally that the government shall procure “domestic” goods and services, but allows for exceptions. The law is framework legislation and contemplates sector-specific implementing regulations, which would, among other things, define the scope of “domestic” goods and services and also provide

for any exceptions to the general “buy domestic” preference. China has identified software as the first sector in which to implement the Government Procurement Law.

In November 2004, China’s Ministry of Information Industry and Ministry of Finance released an outline of the draft software regulations that would define “domestic software” very narrowly -- to qualify, a product would have to be made in China, IPR would have to be held by a PRC person, and China-based development costs would have to comprise at least 50 percent of total development costs. If domestic products or services are not available, the draft regulations would permit foreign software to be considered, but only if the foreign firm conducts certain (yet to be defined) levels of China-based research and development, investment, subcontracting, or taxable transactions. In March 2005, China released a more complete draft of the measures, which maintains many of these restrictive conditions.

The proposed regulations would put U.S. firms at a significant disadvantage in the Chinese market. In a country where piracy of computer software is rampant, the government is one of the few organizations actually willing to purchase legitimate software. Indeed, at last year’s JCCT meeting, China committed that all government offices would use only legitimately purchased software. While China has taken steps to follow-through on that pledge, the procurement policy threatens to undercut its value to the United States. We have made clear to China, including at senior levels, our serious concern with the draft measures. This is the wrong policy for China to implement, given the \$160+ billion trade deficit in goods with China. We continue to raise this issue with Chinese officials at every opportunity, and it is a major element of our bilateral engagement.

In addition to bilateral efforts, [we are working through WTO mechanisms to try to ensure that software and other U.S. firms have access to China’s procurement market](#). When China acceded to the WTO in 2001, it committed to initiate negotiations to join the WTO Government Procurement Agreement (GPA) as soon as possible. We have urged China to honor that commitment by beginning those negotiations now to open its procurement market, to ensure that all U.S. firms can compete in China’s vast procurement market on the same basis as Chinese firms. This move would not only honor China’s WTO commitment; it would also serve China’s interests to have competitive procurement markets.

GPA accession will represent another critical step in China’s integration into the world economy. To help China in this effort, we are providing technical advice and other assistance, while we continue to press China to commence its GPA negotiations without further delay. We are coordinating these efforts with other interested WTO Members.

In addition to utilizing points of leverage, we ultimately need to persuade China with ideas, and we believe that the power of free markets should convince China that its proposed policy is mistaken. Chinese ministries claim that the proposed software policy is designed to help China’s nascent software industry develop. We believe that the proposed regulations will not only limit our firms’ interests in China, but also will reduce investment in China by foreign firms, and will reduce the incentive for Chinese software makers to improve and refine their own products – the exact opposite of China’s goals. A software industry cannot develop behind a wall; Silicon Valley succeeded because of conditions that encourage the free flow of ideas and robust competition, as well as strong IPR protection and enforcement.

The best way to improve China's software industry is to enact and enforce effective IPR laws that provide a level playing field for all software makers. Without strong IPR protection, Chinese firms will not be able to fully capitalize on the creativity of Chinese programmers and service providers. We have made this point clear to the Chinese Government, and, of course, improving China's IPR regime is a major part of our bilateral agenda with China.

Conclusion

Mr. Chairman and members of the Committee, thank you for providing me with the opportunity to testify. I look forward to your questions.